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FEDERAL FINANCE IN A DEVELOPING ECONOMY

Lady Ursula Hicks

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PREFACE

The Indian Institute of Public Administration is glad to bring out its second publication in the series 'Occasional Lectures'. The series is being brought out by the Financial Management Unit of the Institute, under the guidance of Dr. M. J. K. Thavaraj, the Head of the Unit.

Lady Ursula Hicks needs no introduction to students of Economics and the subject covered in this publication has been presented in her inimitable prose.

I must acknowledge the assistance rendered by Shri K. B. Iyer, Training Associate, in editing the publication.

G. MUKHARJI

Director

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Federal Finance in A Developing Economy*

I HAVE been asked to address you on Federal-State Relations, with special reference to developing nations. But after all, most nations are developing. I do not know if the problems are so different. But I do want to approach the subject from an international standpoint. There are a number of problems of financial relations, which may be of interest to one another. For instance, there is a lot in common in respect of institutional arrangements between United States, Canada, Australia and India. One should also have added Nigeria. But one just does not know what is going to happen there. They threw away their Federal Constitution. Whether they can bring it back again is not known. But I can speak of arrangements in Nigeria which I knew very well indeed but, at present, only in the past tense.

There has been a very great increase of interest, in this subject in recent years and a great deal of rather recent literature some, of course, in India with the report of the Fourth Finance Commission, for which I wrote a memorandum, as I have done for the previous Commissions. But this memorandum has been published by the Institute of Public Opinion.

The working paper, issued by that Institute last October, was full of useful facts and statistics. Recently, I have made fairly extensive researches about the Australian federal financial relations. I have published these in an article comparing

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Australian and Indian arrangements in an international journal called Public Finance.

All federations have common problems and they are very tricky ones. First of all there is the problem of fiscal imbalance. The federal government must be allowed to have the best and the most elastic taxes. These are the taxes which will increase relatively in revenue as incomes rise. On the other hand, the States usually have important responsibilities particularly in regard to education which is by far the most costly of social services and the demand for education continually rises. While the costs of education continually rise the States' revenue is always pretty inelastic, so that the imbalance, tends to get worse as development takes place.

Secondly, all Federations have a problem with which we are very familiar in India, namely, the uneven potential of the States. Some States are wealthy, others are very poor. This happens everywhere. But, of course, wealth and poverty may change overnight, for instance with mineral discoveries, with successful development of industries and so on, so that this problem is one that has to be watched all the time, and for which I am sure a flexible policy is necessary.

The third problem is the location and multiplier effect, if any, of large national projects. This may make a very great difference to a State. The location may be fixed on political grounds, or it may be fixed on ground of natural advantage such as the presence of raw materials.

One of the basic reasons for the Nigerian trouble was that oil had been found in the Eastern region. There was a revenue arrangement whereby, wherever the oil was found, the concerned region would have 50 per cent of the profits, plus a share of the other 50 per cent. This was all right so long as oil revenues were small, but then, suddenly the picture changed with large new finds of oil and everyone wanted to take a larger share of oil revenues. On the other hand, some projects may have virtually no multiplier effect. For example, let us reflect on all the investments that have gone into Bihar which still remains a poor State.

Then, governments all over the world are confronted with the basic dilemma in policy. Everyone wants wealth. Most people want redistribution. When I say 'most people' I do not think the Germans and the Japanese are much interested in it. But certainly all British Commonwealth countries are very much interested in redistribution, and the problem is : are we going to give more for growth or more for redistribution? Whichever we decide on is going to influence very much our whole policy, but especially our policy as between States. Are we still going to give more to the States who will do better, raise the GNP more rapidly, or are we going to put all our money on to the poor little States, who really have no resources and who even when we put a lot of money on them, won't be much better off and the GNP won't be much better off either? This is a very difficult problem; but, every country has to face it.

Whatever the degree of our problems, success depends on having stable government in the Centre and in most of the States. I think in this respect, the number of States in the country is relevant. Australia and Canada both have a reasonable number of States, nine or six. The Federal Government can know them all intimately and about what they do.

The reasonably highminded British administration that established Nigeria did not really have much sense about all that. They established three States or regions, which meant that it was always two against one and the other one fighting; but worse than that, one State was twice as big as the others.

The United States, of course, has so many States that it cannot look at them all individually. I think they are getting more into the habit of looking at them in regions—the eastern seaboard States, the middle-west States, the north-western, the deep south and so on, and dealing with them rather as regions, as indeed India is doing to some extent. Probably, if India has a lot more of States, that is, at least, one way of getting greater cooperation between Centre and States.

Of course, even in the other Federations, apart from Nigeria, there is not the same interest in global planning as there is in India. The United States is only beginning to think about planning. It is thinking very hard now, particularly at the level of the large cities.

Australia has very active planning at the State level. The Commonwealth Government does very active planning in its two "sanctuaries", what you might call its presidential rule territories, which are the Australian Commonwealth Territory round the capital, Canberra, and the extreme north of Australia, which has not been settled, which is inhabited by aborigines, is very hot and so on, but suddenly has developed terrific potential through the discovery of a large range of minerals; which the Commonwealth Government is actively engaged in developing.

So much for the basic dilemmas and problems that every Federation has to face.

Now, let us look at their financial provisions—first of all their constitutional provisions. I daresay those who are familiar with the study of public administration and so on, have come across Prof. Wheare's book on Federalism, where he says that the Federal Government, or as he calls it the General Government, and the States should have equal, independent rights within their spheres. Now, I do not know if this was ever true. But it certainly is not true of any Federation at the moment. Due to the basic fiscal imbalance, which I have mentioned, there must be transfers of resources from the Federal to the State Governments. Because also of the now universally recognised need for a national policy, there must be some control over investment and borrowing, debt servicing and so on, so that federations, as they are now, are bound by certain transfer arrangements and some controls. It is often thought that Central Governments are gaining on State Governments in stature, and I think this is broadly true. In Australia for instance, some people are inclined to say that they are heading for a unitary government. I do not think they are. There the State interest is very strong. And on the other hand, some

Federations have blown up because of divisive forces which could not be controlled from the Centre.

First of all, as to the fiscal State rights, in all Federations, personal income-tax is now federal, though it was not so in Nigeria. It was a State matter, apart from the Central government area round Lagos. In the U.S.A. there are concurrent tax rates, and in certain States individuals may find that they have to pay Federal income-tax, State income-tax and City income-tax as well. I do not think this is a good arrangement.

On the other hand company tax is always basically Federal, although in fact, in the United States, some States find good ways of getting quite a lot out of companies. I feel sure that company tax has to be basically Federal, because firms, both indigenous and expatriate firms, operate in a number of States and it will be awful for them, if they have to face different taxes and different tax provisions in different places. But company tax, of course, is one of those taxes which has good elasticity, and is one, which, as development and industrialisation take place, will bring more and more revenue to the Federal government and not to the States.

Customs duties are always federal. They have to be because these impinge directly on the balance of payments, and the Federal government is responsible for the good health of the balance of payments.

Excises do not quite so obviously have to be federal and sales taxes may be regarded as excises. The nomenclature of excise taxes is very vague and confusing. Some people mean by excise something quite different to what other people do. But generally speaking, it is usual for most excise taxes to be federal. On the other hand, in the U.S.A. they are mainly State. But they are also concurrent. In Nigeria they were all federal. Here in India you have a pretty good mixture. States in India, however, can have sales taxes and some of them do very well out of them. It is interesting that the U.S.A., the

richest Federation, and India not necessarily the poorest—but a poor Federation—both have the bulk of State revenue coming from sales taxes.

In India there are other taxes. There are for instance, land revenue and agricultural income-tax which are exclusive State sources of revenue. There are also octroi duties and taxes on professions and occupations. Octroi is a very nasty tax but the unfortunate thing is that it does bring in quite a lot of revenue, although, I am sure very little in relation to what might be raised.

On the whole, I do conclude that the tax rights of Indian States are as good as in any other Federation, except the U.S.A., where you have the concurrent income-tax. But then India has a very large devolution of income-tax and some devolution of excises. Of course in every Federation, the extent to which the States use their fiscal powers differs very greatly. It does here certainly. I think it does in the U.S.A. In Nigeria it differed enormously because the backward people of Northern region could not face an income-tax; and altogether, they were not really interested in development.

Now, how about tax devolution, or as they call it in Nigeria, revenue allocation ? India and Nigeria are, or were, both on the same system, because they were both planned by Sir Jeremy Raisman who was once the Finance Member of the Indian Dominion, and who was also asked by the British Government to plan revenue allocations for Nigerian independence. This means, first, the quinquennial Finance Commissions, all constituted quite separately with new people. Secondly, percentages of selected taxes are transferred to the States from the Centre. Thirdly, there is an allocation or transfer between the States, on a not very clear basis: no analysis is given by the Finance Commissions; there is only vague general statement; for instance, by the last Finance Commission in Nigeria that they were giving some weight to population and some weight to the commitments of the States. Probably their allocation was a bit more redistributional than Finance Commissions in India have in practice been.

When I was asked by the eastern region, the Ibos, to act for them in the last allocation in 1964, I thought I would try to find out the basis of the previous percentages. So I wrote to one of Sir Jeremy's commissions, asking how it was done, and I was told that there really was no basis.

Everyone in a democratic country has a right to know the basis of such financial transfers. There should be a proper analysis to show as to why the allocation was made to a particular State. But this does not seem to be the idea behind the Five Year Finance Commissions.

In Australia, as I shall explain, the matter is arranged very differently. It is done through an independent body (not a statutory authority), called the Commonwealth Grants Commission, which is representative of the Federal Government, the States, with als) a couple of academics. Their allocations really come under a heading, different from tax devolution as it is really a system of grants.

I am talking first of grants outside the Plan because this is a comparable thing with the other Federations. Here in India, the Finance Commission gives grants or recommends the same under provisions in the Constitution. These are redistributional. But the total allocation is not really redistributional and the grant element is really very small. There is the transfer to the States of additional excises, that is to say, State sales taxes which have been taken over by the Union Government. We know that each State was guaranteed the same amount as it had collected in the last year in sales tax before it was taken over by the Union. The surplus is distributed by the Union Government in a way that is not very clear to me. The States are unhappy as they had been collecting good money by sales tax. All they get now is the money they collected years ago. That is to say, the whole elasticity of the tax has been transferred to the Union. To that extent State finance is less autonomous than it was before. Nevertheless, of course, the Union is a much better collecting agency than any State was before.

In Nigeria, the most important grants, apart from the Finance Commission allocation, were for education, and these

were based strictly on local effort. The grants were for teachers —teachers coming up to a certain standard, of course—and a certain amount for assistance in building schools. In Nigeria it is their habit, for the local people to build the primary schools by their own efforts. For secondary schools and technical things, they have to have Federal help. The allocation was based on what they assumed the local bodies could raise; and the local bodies, did raise it, because they were meant for education, except, as I said earlier, in the north.

In Australia, the Commonwealth Grants Commission makes grants to what are called the claimant States—that is the poor ones, which are at the moment, two, *viz.*, West Australia and Tasmania. They also get Finance Assistance Grants which started off as a reimbursement when the States agreed to give up their income-tax during the war. The grants to the claimant States are fully redistributional, and as a matter of fact, the Finance Assistance Grants are also redistributional, and they have been growing very fast. The position in Australia is just parallel to here—the formal constitutional grant, in India's case, of the Finance Commission, in Australia of the Commonwealth Grants Commission—is now much less important finance-wise than grants under financial assistance in Australia, and plan grants in Australia which they call Specific Purpose Grants, and which are also showing a great tendency to expand.

Just a word about capital finance. In Australia and in Nigeria, as well as in this country, foreign loans are closely controlled. In India, internal loans can be raised by the cities as well as States. In Gujarat, they have just* had a stock exchange loan, which has been over-subscribed three times. It looks as though there is money in Gujarat. But on the whole even internal borrowing tends to be controlled in some way. In Nigeria, the States had power to raise loans under certain conditions, which generally were not fulfilled, and here, I think it depends to some extent on how much the State is in debt to the Reserve Bank. But in Australia the whole business is managed through another independent body, the Australian

*January, 1970

Loans Commission, where the total external borrowing for the whole of Australia, Federal and State is determined once a year through the deliberations of this body, which is representative of the Commonwealth Government and of the State Governments. Then the States put in their claim for what they hope to get and they are allocated according to what is conceived in the national interest, *i.e.*, their share of the total which the Loans Commission thinks is wise to borrow abroad. At one time this was immensely important. In fact, the Loans Commission had its origin because of very great over-borrowing on the market by some of the States which bankrupted themselves, especially Queensland which had to be baled out by the other States. But States that are trying to develop fast, find the Loans Commission a bit of a restriction.

In the Australian system there cannot now be any over-borrowing by States as there has been here in respect of the Reserve Bank. So much for the different forms of finance available to States. I would now like to talk about the differences between India and the other Federations which are greater in practice than they look as if they would be under the Constitution. In this country you have a very important element of the incidence of Plan outlay and its finance. As we all know, it is extremely complicated. On the whole, it would seem that the plan grants are redistributional. But, as I said, it is not really true of the Finance Commission Grants. In the U.S.A. most of the grants to States seem to be on what they call a matching basis. I used to think that matching meant 50/50. Not in the least. It can mean, as far as I can see, 90 Federal and 10 State, perhaps even less. But their principle is, and I am sure it is a good one, nobody should have 100 per cent grants, generally speaking. Because, if they do, of course, this takes away a lot of the incentive for careful management.

Broadly, then, one can say that some of the grants in this country are redistributional. As far as I can see, the plan grants are so. But this raises a certain doubt in my mind as to whether the plan grants should be redistributional, since

the plan presumably is to raise the GNP directly, which would suggest that what ought to be redistributional would be the Finance Commission Grants, and what ought to be based on economic considerations would be the plan grants. But, of course, the truth is that the plan grants are very much more flexible than the others.

Now, in Australia all this is done through the Commonwealth Grants Commission. The basis of their federal grants, corresponding to the Indian Finance Commission Grants is that they should endeavour to put the poor States, the claimant States, in a position in which they can indulge in the same per capita outlay at the same level of taxes as the standard States which are New South Wales and Victoria, the two richest States. And the Grants Commission attempts to measure this by three elements : a budget element, a revenue element, and an expenditure component. The budget component is to see that the deficit of the poor States does not exceed the deficit of the standard States. If the standard States have a deficit, then the claimant States are allowed to have a deficit; that is to say, it won't be completely closed for them by the Grants Commission. If the standard States have a surplus, it does not imply that the claimant States have to raise their taxes to get the same surplus. They can be satisfied with just a plain balanced budget. The revenue component is a matter of estimating what the poor States could raise without too much difficulty. It is recognised that this will depend on the population, on the per capita incomes, on the distribution of State incomes and on the distribution of age among the population. It is a very sophisticated estimate. It corresponds to the estimate that Planning Commission here has been making on relative backwardness. You have probably seen that this depends partly on incomes, partly on such things as miles of surface roads, mileage on railways, use of electricity, proportion of workers in factories, etc. But I think that the Planning Commission is more geared to purely economic considerations, whereas the revenue potentiality estimates in Australia are rather more inclusive, including social considerations as well. Well, anyhow, what the States could raise

is taken into account while determining the grants and if they do not raise it, their deficit will remain uncovered to that extent.

The third component in the estimate is based on three categories of expenditure. First, they should be able to spend the same, if they want to, as the standard States on, first of all, education, secondly, health, hospitals and charities, thirdly law, order and safety and so on. The Grants Commission estimates are based on fundamental comparisons of this nature and they are extremely sophisticated. They are forward-looking taking into account the projected needs of the next five years although they will be considering them every year.

But there are two important differences here. First of all, the estimates are backed by numerous consultations in the States. They could have as many as 27 consultations in a year about all this business. The Commission goes down to the individual States. First it meets in Melbourne, which is the home town of the Commission and also in Canberra, which is the seat of the Government, and consequently of the purse strings. The States do not keep uniform budgets because the Constitution does not give the Commonwealth Government any power over that. But the Commission knows so much about the components of the State budgets that they can adjust them into a strictly comparable form. The States do not in any way resent all these discussions. In fact, they like them. They say that people coming from outside can sometimes show even very capable State Treasurers things that were wrong, but went unnoticed. The whole exercise is, and is meant to be, educational.

As you will see, the Grants Commission goes minutely into the budgets of the claimant States, but it also does so of the rich ones, so that over the course of years, a very intimate knowledge of State budgeting and its implications is acquired. Thus the one great difference is that discussion on the grants takes place every year. The second is that everything is published. Reports of every meeting with the States and what the States put in to support their claims are published immediately. Everyone thus knows just where the States stand,

and on what the Grants Commission is basing its decisions. In fact, they have developed what they are glad to call, a "cooperative federalism". If you do not have proper cooperation between the Federation and the States, you will never get the best out of planning or any sort of development policy.

In short, it seems to me, just as an outsider, who has taken a great interest in the federal aspects of Indian finance, that the greatest weaknesses of Indian federal-state relations are :

First : the lack of effective budgetary control over the State budgets, due partly to ignorance and insufficient data; partly to the fact that the Finance Commission is here today and gone tomorrow, and gets rid of its information; and partly, no doubt, because of the great number of the States and the instability that has been in them. But I feel sure that full cooperation in the States cannot be obtained until there is some sort of common working and discussion at great length, not just in a day or two or in a hurry.

Secondly, I would say it is a great weakness that the Union Government is really not able to make the States tax themselves adequately. This is a trouble also in the U.S.A. where they have developed a number of rather sophisticated measures of tax potential. In Australia the Grants Commission has developed them.

In this country, so far as I can see, the Planning Commission or the Cabinet has to rely on the good intentions of the States. We all know what is paved with good intention—perhaps, nothing that will aid development! If we look at State taxes in relation to per capita incomes, the results are certainly very odd. In the quarterly Journal of the Institute of Public Opinion, there were figures given for 1967-68, figures of relative tax burdens or turning it on its head, relative tax effort. On the top of the list, the best taxed State is Kerala. Quite clearly, this is partly to its heavy education expenditure. The second best in tax proportion to income is poor little Bihar, which does not have any income anyway, but evidently taxes them right away. The third is Rajasthan which has a

fairly good income, not very much. But let us leave it at that. Go through the really low tax in relation to income and here we find Gujarat, Haryana and Punjab at the bottom of the list—the three richest States. Maharashtra is not all that good. Punjab is very important. No doubt it is said it has good intentions. But it does seem it does not tax itself.

The third weakness, I think, is the inadequate discussion of Federal transfers. It is horse-trading, just the same as in Australia. There is always horse-trading, if you like to call it that. But what we have here, is telescoped horse-trading, because it is all rushed into rather a short period, very different from the lengthy intimate discussions in Australia.

All of this seems to boil down to a lack of communication and cooperation which in Australia is supplied by the Grants Commission, and, which, in my view, could be supplied by a permanent Finance Commission. It takes some time to build up a corpus of knowledge and intimate relations; but, if there were a continuing Finance Commission a start could be made, and I think even in a few years, the benefit could be apparent. If, however, this is not politically to be contemplated—I cannot see that it has party implications—I have been wondering whether it would be possible to arouse a nation-wide enthusiasm which would embrace all States on certain productive cooperative items which have both Union and State relevance. The sort of thing I have in mind is the road structure and network, plus transport arrangements. It is no use thinking about roads without also on what has to go on them. It is no use thinking of the most efficient transport unless we know what we are going to do about the roads.

And another thing would be water resources. In India, as in all countries that depend heavily on the monsoon, something has to be done to find out what water resources there really are down underneath. And if we are near mountains, of course, then we can have canals. But in many ways it seems tube-wells can be sunk in a great many different places and these are really more effective than canals. They do not silt

up in the same way. They are not so heavy an investment. Consequently they do not raise much in the way of debt and interest charges. But this is a thing which concerns nearly all the States. Kerala is nice and wet, and over on the west side they are a bit wetter. But even so, the green revolution in India would expand and it would be much more stable if there could be a common interest and policy about water resources.